

The Political Economy of the Free Market

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Abstract

This article focuses on the role that political economy (i.e., governments) play in setting the rules of the free market with regards to property, monopoly, contracts, bankruptcy and enforcement, and how these rules can be framed to favour certain groups over others, leading to the widespread inequality that we see in today's world. This article will examine what the term "free market" means, the justification for this form of organisation, and whether it is implicitly rigged or rigged due to specific government and legislative structures.

An Introduction to the 'Free Market'

A market refers to an institution where individuals or agents come together to voluntarily exchange goods and services, the value of which is usually measured in terms of a common denominator - money, the medium of exchange. However, markets, throughout history, have never been viewed as purely economic institutions (though the establishment of economics itself as a discipline in its own right post-dates the creation of a marketplace), they have always carried moral connotations as well - negative associations with the sins of "greed" and "gluttony" and an opposition to the existing establishment, but also positive associations with individualistic liberty.

The justifications and criticisms of markets tend to be steeped not only in economics, but philosophy as well. Sen (1985) bifurcates the justification for free markets into a justification based on rights and liberties or the consequences of the same. The rights in question are concerned with entering into voluntary exchange transactions with individuals or agents, based on the right to private property. Such a justification for markets based on rights is often used in tandem with the idea that the right to private property predates the establishment of the state, so any interference with this right by the state is perceived to be an overreach. A consequential justification for markets is based on the outcomes that it leads to - it encourages sociability and rational interests as opposed to "violent passions" (Stanford Encyclopedia of Philosophy, Markets). According to Zupan (2011), free markets also promote trust and integrity through the possibility of multiple exchanges - "the more the future matters, the better behaved individuals are in the present." Labour markets are also said to recompense individuals based on their efforts to make society better off as a whole, an argument that is based on notions of personal responsibility. The most important argument in favour of markets is one that also provides the most basic justification of a free market system.

A market is said to be free when it is based on voluntary exchange between different parties, with minimal intervention from the government. They have decentralised structures and the absence of coerced or conditional transactions. A pure free market economy, one without any form of governmental intervention is hard to find, however there are several economies that are close to this definition of a free market. While the

relationship between the state and the market under a free market system appears to be negatively correlated, this view is not fully accurate. In the words of Dean Acheson, “the problem with a free market economy is that it requires so many policemen to work”. The state is required to lay down the rules of the free market, and secure many of the preconditions for a free market - for example, the state must enforce contracts for the functioning of a free market system, and also respond in cases of market failure. The state, therefore, cannot purely be characterised as an “intruder” in a free market system.

Proponents of free markets tend to use lines of argumentation that prioritise the concepts of freedom and liberty above all else when opposing government intervention. This, however, requires a deeper examination of ‘freedom’. The freedom that an individual is allowed in a free market system is the freedom to act independent of coercion. This is what is known in philosophy as negative freedom. Positive freedom, on the other hand requires not only the absence of coercion or force, but also the ability to exercise autonomy or self determination. Is this a metric that one can see fulfilled in a free market system? In a free market system, the autonomy that an individual can exercise often becomes a function of the market as well. One’s ability to take control of one’s life is a function of the level of educational attainment, access to healthcare, state infrastructure etc. Such a criticism of the free market is not new. In “State Intervention versus Free Market”, Ghosh (1992) writes:

“Effective demand in economics is demand backed by purchasing power.... So if effective demand has to be backed by purchasing power; and purchasing power comes from the ownership of assets and resources. The distribution of the current social product also depends on control over the resources which generate the social product. You have the genesis of ‘market demand’ therein, by way of control over the distribution of the social product, through control over the resources that lead to the generation of the social product. The ‘market friendly’ approach is therefore nothing more, and nothing less, than an approach that favouring the extant distribution of income and wealth, the extant control over the resources of a community.”

Favouring the existing distribution of wealth and resources is reflected in economic theories as well. The Pareto efficiency criterion defines an allocation of goods as ‘optimal’ if there is no way to redistribute or reallocate goods to make at least one individual better off without making one or more individuals worse off. This is favourable for groups and individuals who are already better off, because it makes a change to status quo, by reallocating goods and resources, inefficient in nature. Regardless, the justification for wealth that individuals have earned through exchanges in the market is a part of one of the most powerful arguments for the free market.

Under a free market system, all exchanges that take place are voluntary in nature, and at the end of a voluntary exchange, each party is better off than it was at the start of it. If they did not believe that they would be, then they would not enter the exchange in the first place. This argument also accounts for the subjective judgement of an individual. It allows an individual to ascertain for themselves what would increase their welfare, and enter into a transaction based on this belief. As both parties perceive themselves to be better off after the trade, each transaction increases the level of

welfare in society. Therefore, an individual who has participated in multiple transactions has made those many people better off, and this is the foundation of their claim to their wealth.

Free Market Rules

Free Markets and Wage Setting

A trade union is an organisation that has been formed by workers from related fields that works to advance the interests of its members. Trade Unions are usually formed to work towards improvements in pay, working conditions, and benefits through collective bargaining. They also influence the terms of employment for non union members through spillover effects in the market. Collective bargaining is an extremely important feature of unions because of the inequality of bargaining power that exists in the labour market. Bargaining power is said to be unequal when one party has more and better options than the other party and is therefore in a better position to negotiate. The recognition of unequal bargaining power within the labour market is not one that is novel. In the *Wealth of Nations*, Adam Smith writes,

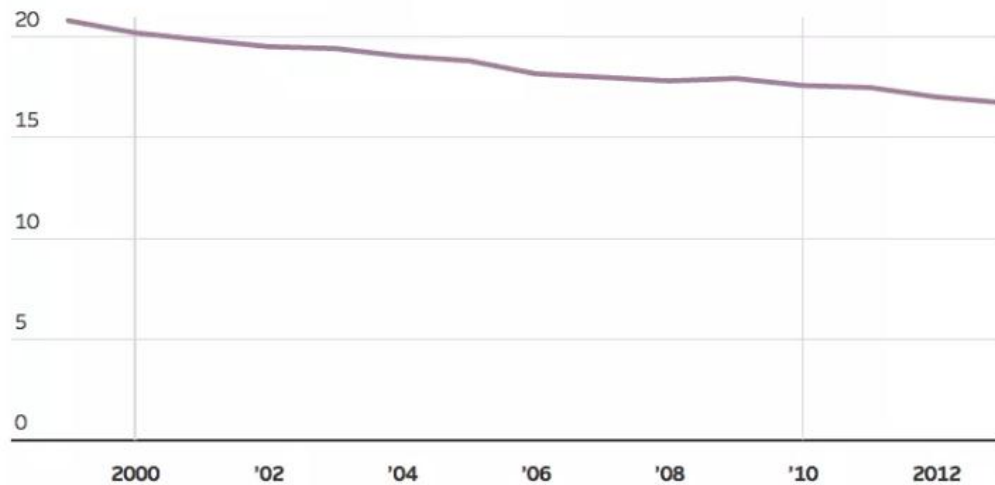
“The masters, being fewer in number, can combine much more easily; and the law, besides, authorizes, or at least does not prohibit their combinations, while it prohibits those of the workmen. We have no acts of parliament against combining to lower the price of work; but many against combining to raise it. In all such disputes the masters can hold out much longer. A landlord, a farmer, a master manufacturer, a merchant, though they did not employ a single workman, could generally live a year or two upon the stocks which they have already acquired. Many workmen could not subsist a week, few could subsist a month, and scarce any a year without employment. In the long run the workman may be as necessary to his master as his master is to him; but the necessity is not so immediate.”

While it is true that unionising is no longer illegal in most of the world, “union density” (the percentage of the total number of workers in a given location who are trade union members) varies significantly across countries: from 90.4% in Iceland to 1% in Myanmar. As inequality has risen, unionisation worldwide has fallen. According to Western and Rosenfeld (2011), the fall in unionisation accounts for a fifth of the growth in men’s earnings inequality, and if the normative impact of unionisation on non-unionised wages (there is a positive correlation between the two) is considered, then the decline of unionisation accounts for a fifth to a third of the growth in wage inequality.

Now, it is intuitive to view unions as possible monopolists, restricting wages in the free market. Under such a conception of a trade union, it violates the rules of the free market. However, it is possible to view labour unions as a free market solution to a problem that arises from within the free market. A labour union can be viewed as a “employee-owned businesses that sells labor”.

The falling OECD unionization rate

Share of workers in OECD countries who are union members, 1999 through 2013

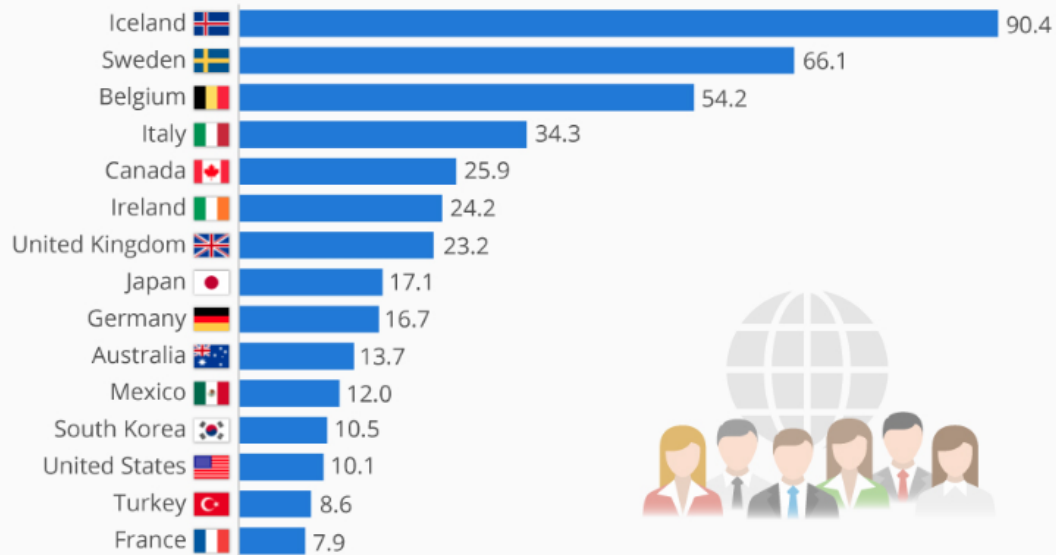


Source: OECD



The State Of Global Trade Union Membership

Trade union membership as a percentage of total employees*



* Selected OECD countries (2018 or latest year)

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Source: OECD

statista

Competition in free markets

Competition is an essential component of markets, and results from scarcity. There is never enough to satisfy all conceivable human wants and a free market with the tools of demand and supply determines who gets what. In offering goods for exchange, buyers competitively bid to purchase specific quantities of specific goods which are available, or might be available if sellers were to choose to offer such goods. Similarly, sellers bid against other sellers in offering goods on the market, competing for the attention and exchange resources of buyers. Since, there are ideally no external influences in a free market, it efficiently sets the economic equilibrium through competition.

In a competitive free market, entry and exit of firms are unrestricted which grants the market its highly competitive in nature. With increase in competition in a market, the price elasticity of supply increases i.e. with a small change in price, the quantity supplied in the market alters drastically. On the other hand, in a monopoly where a firm is the sole producer of the good and has no competition, it can set a price according to its own will (although it is a given fact that a rational producer will always choose the price and quantity at which it is able to maximize its profits). In a free market, such kind of power can be harmful for the economy and that is exactly where governments may play their role (for example, by providing subsidies to the producer to cover the loss it would incur to produce a quantity with is more than the equilibrium quantity) but a free market arrangement does not allow such interference thus often leading to shrinking of the market size. Different tests can be applied in order to identify a market under a monopolist. It is possible to view the existence of a high market share to be the same as having a high degree of market power, but the traditional test that government authorities use to test for monopolies is known as the SSNIP test - it is concerned with testing the impact of a hypothetical Small but Significant Non-transitory Increase in Price on the profitability of the firm. If there is demand side substitutability (when customers can switch demand to 'substitute products') or supply side substitutability (when firms operating close to the market in question can supply similar products to customers at lower prices), then such an increase will lead to a significant drop in the sales of the firm and profits will fall (Griffith and Geroski, 2003)

In cases where a monopoly market is identified, laws such as antitrust laws may be enforced, making the market healthier by restraining price-fixing conspiracies, corporate mergers that are likely to cut back the competitive fervor of certain markets, and predatory acts designed to gain or hold on to monopoly power.

Free trade

Free trade is a free market idea applied to international trade : a trade policy that does not restrict imports or exports, thereby allowing for voluntary, cross-border exchanges. Free trade was best exemplified by the unilateral stance of Great Britain, who reduced regulations and duties on imports and exports from the mid nineteenth century to the 1920s. Today, most nations are under are members of the World Trade Organization, and there exist multilateral agreements which allow free trade among them.

But before we get into the merits and demerits of free trade, we must first understand what it actually means ; the trade of goods and services without taxes (including tariffs) or other trade barriers (e.g. quotas on imports or subsidies for producers), the absence of "trade-distorting" policies (such as taxes, subsidies, regulations, or laws) that give some firms, households, or factors of production an advantage over others, unregulated access to markets and market information, and the inability of firms to distort markets through government-imposed monopoly or oligopoly power.

David Ricardo's theory of international trade suggests that trade between countries is always beneficial as long as they have comparative advantage (or lower opportunity cost) in the production of at least one good. If both countries produce the good in which they have comparative advantage and exchange it for the other one, they both gain. However, the degree and the nature of these gains changes - as nations internalise, they gain less and less through globalisation. Within countries too, they find, the gains from globalisation are concentrated at the top of income brackets, resulting in higher inequalities.

However, if the government interferes and distorts this free market arrangement, then what happens? Suppose if a tariff is imposed which raises the price, the producer surplus increases while the consumer surplus decreases. Along with it, the total surplus falls, as the society faces a deadweight loss. Then why do governments opt for taxation despite its ill effects that shrink the market size? The answer is protectionism and generation of public revenue. This, nonetheless, is only one side of the argument. While it is true that globalised economies tend to have more unequal market outcomes, the net outcome (post the redistribution of resources by the government in the form of taxes and transfers) appears to be positive (Lang and Tavares, 2018).

Now, where does this analysis leave the free market and the state? Scott (2011) proposes that as long as the free market is solely focused on the maximisation of individual incomes, and not the maximisation of societal benefits on the whole, it does not guarantee or approximate a socially optimal outcome. Ricardo's theory of trade also suggests that globalisation will impart both gainers and losers - along with the idea that the benefits from globalisation must also be used to recompense those who have been harmed by it.

Conclusion

Like all attractive systems of operation, the free market too suffers from limitations such as income inequality and market failure. Income inequality is a pressing issue in most countries of the world that are open to the adoption of free markets, or more specifically, free trade which encourages exports of high-quality and often inexpensive goods and services, thereby promoting employment among highly skilled individuals, or those who can offer their labour inexpensively. These increased imports of goods made possible by free trade, however, concern products that require more low-skilled labor. As a result, free trade causes upward pressure on wages of highly educated people and downward pressure on those of low-skilled people, which also increases income inequality.

Market failure is a situation defined by an inefficient distribution of goods and services - leading to net social welfare loss - in the free market, in which the individual incentives for rational behavior do not lead to rational outcomes for the group. Such a situation forces the government to interfere and tackle externalities which occur when one person's actions affect another person's well-being, without the relevant costs and benefits being reflected in market prices. The state also provides public goods, ensuring that consumption of a good by one person does not reduce the amount available for others to consume and the benefits a person derives from a public good do not depend on how much that person contributes toward providing it. In such a situation, everyone benefits, but perhaps in differing amounts.

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